

THE ECONOMY OF BULGARIA – APRIL 2009

SUMMARY OF THE REPORT BY THE CENTER FOR ECONOMIC DEVELOPMENT

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MACROECONOMIC DYNAMICS: *The crisis in Bulgaria is developing with a delay of two to three trimesters in comparison with the crisis of the economies of the Western European countries. The foreign environment, which brought the crisis to Bulgaria, continues to be in a period of recession.*

It is very likely for the **aggregate economic growth in Bulgaria for the first quarter of 2009 to be negative – approximately minus 1-2 percent on an annual base**. The expectations for the **full year 2009 come in two versions**. The **pessimistic** is that, due to a delay in the restoration of growth in the EU, **a decrease is to be expected in Bulgaria, too**. The **optimistic version** is that the restoration of growth from internal forces, and with a more favorable external environment during the second half of the year, will lead to **growth for the year of approximately 1-2 percent**. Delay of growth in the agriculture sector is to be expected; the growth in the services sector will fluctuate between 0 and 1 percent. There will be a decrease in the growth in construction and a drop in the industry sector at least until the middle of the year. The more optimistic expectations are connected to the possibility of maintaining a minimal growth or at least a minimal one-time drop in final consumption. The real, even if extremely low, growth in investments continues to be completely attainable – in the case of optimal use of the resources from European funds. The drop in foreign trade will continue until the former foreign demand is restored or partially redirecting towards other countries. The redirecting of consumption (final as well as intermediate, as far as possible) from foreign to domestic industrial commodities and some services (tourism, transport, business services, etc.), would be favorable to the optimistic version as would the seeking of opportunities for certain redirection of exports to markets, which are less affected by the crisis.

Regardless of the halving of the growth in **GDP** during the last quarter of 2008 (3.5% as compared to 6.9% for the last quarter of 2007), the GDP's growth for the full year 2008 is negligibly slower than the growth for 2007 (6.2% compared to 6%) because of the record-breaking pace over the first three quarters. **Manufacturing, as a component of the production side of GDP**, caused the most concern during the last quarter; the worsening of the industrial sector, which is due to the deepening of the drop in value added by industry, began back in the third quarter. The dynamics in the construction sector also slowed several points, but it was still positive. However, the shrinking of the growth in the services sector, whose share in GDP is predominant, held the greatest weight regarding the general slowing of the growth of the economy. In breaking down the dynamics of the final use components of

GDP for the last quarter of 2008, we can observe an abrupt shrinkage in the growth of household consumption, a drop in collective consumption, and a slowing in the growth of investments as compared to the previous quarter (but the interesting thing is that it remains higher than the growth a year ago). Taking into consideration the influence of the unfavorable international environment, the drop in foreign trade in goods and services was most expected.

In the fast changing situation during the last months, the *monthly data for the real economy* give a clearer picture of the formation, the direction, and the speed of the current processes. They are a better reference point for expectations (Fig. 1). **The weakening of the real volume of industrial production** in Bulgaria, which began in October, still continues. In previous years January production has traditionally been significantly lower than that from December, but usually there was growth on an annual basis. What is alarming from this January is that due to the sharply descending dynamics at the end of the previous year, it was below the level from January 2008. The preliminary data for February show monthly growth of 5.6%, but on an annual basis the drop in the industry sector continues to be significant (17.7%). Similar is this year's situation in **construction, where there is also a drop on an annual base, even if lower in comparison to the drop in industry**. In February the drop in construction output continues, on an annual basis, but, it is less (5.8%) in comparison to the January drop. This situation is repeated in the **trade sector**, where the drop deepened in February to reach 10.1% on an annual basis. A significant drop, on an annual basis, has been recorded for January and February in the short-term data for **rail transport**.

The descending trend of the general business climate indicator continued during the first two months of 2009, but was significantly lower, and March brought good news – a rise, even if only by 0.6 points! The improvement continued in April, too, when the business climate indicator increased in comparison to the previous month in all sectors except construction (i.e. industry, retail, and services). This is reason to **expect the economy to return to growth during the second quarter**, even comparatively slow.

The slowing of the economic dynamics in the world, and also in Bulgaria since October 2008, was followed since December until the present by a **shrinking of the current account deficit** of our balance of payments in comparison to the deficit for the same months one year ago. For January-February 2009, the deficit decreased to 649.6 million euro (1.8 percent of GDP) with the current account deficit standing at 1464.6 million euro (4.3 percent of GDP) for the same period in 2008. The decrease of the current account deficit is a result of the lower deficits in the trade balance (by 501.8 million euro), item services (by 170 million euro), and the increase of the balance in Current Transfers (by 148 million euro). The shrinking of foreign trade is characterized by a larger drop in imports. We observed the beginnings of change in commodity and geographical structure as a result of the worsened situation on the market. Under the conditions of difficult access to funding, and shrunk consumption, the influx of foreign capital decreases, but this decrease is in a much less degree than what had been expected. We see no reneging of investment projects, but rather temporizing until the conditions improve. The fulfillment of the projects already begun continues; there is an interest from new investors (Arab investment funds); an agreement with the EBRD for 250 million euro of special purpose credit lines is signed.

There has been a small change in consumer prices since the beginning of the year. The accumulated inflation for the first three months from the beginning of the year reached 0.6 percent (2.5 percent one year ago). By April, the prevalent expectations of business are for a decrease in sale prices. In the construction sector, entrepreneurs, who do not expect a change in their sale prices predominant, but the portion of those, who expect a decrease (15-19 percent) has been stable for five months now. The production assurance with orders in the industry sector is decreasing and continues to maintain the expectations for a lowering of the

sale prices also in the coming months. In the services sector, the expectations for lowered sale prices are predominant and growing. Only retail sales are expected to maintain their price levels. The expectations for inflation among consumers continue to decrease. Taking into account our expectations of a drop in aggregate growth during the first quarter and of weak growth during the second quarter, as well as of an inert increase in consumption at least until the middle of the year, we expect more months of deflation in the area of consumer prices, with more intensive deflation during certain months. We do not expect the annual inflation to grow beyond 3-4 percent for the full year of 2009.

For the first time in several years, unemployment for March and February, which was registered by the local employment bureaus is now a little higher than the previous month even if decreasing on an annual basis. During the last four years the unemployment for these months has been lower than its respective level from one year ago, as well as than the previous month. The macroeconomic effects of the efforts to optimize labor organization with the purpose to increase the productivity and the quality of the commodities and services offered, while simultaneously maintaining the number of employees instead of decreasing them, will increase – or at least preserve – the potential of the households as final consumers and savers in the country.

*The abrupt shrinkage of the aggregate economic development during the fourth quarter of 2008 was the reason for a more significant **slowing of the real growth of the aggregate productivity of the economy**, which sank by 6 times in comparison to the growth from one year ago, as well as compared to the previous quarter, owing mostly to the worsening fall of productivity in industry.*

POLICIES REGARDING BUSINESS ESTABLISHMENTS. The **Bulgarian Development Bank** (BDB) was established in 2008 for the purpose of stimulating small- and medium-sized business. The gradual capitalization of the bank by the end of the year began with a total of 500 million levs. Since the beginning of 2009 BDB has given 230 million levs to 12 commercial banks for loans for small- and medium-sized companies. With the purpose of encouraging research and innovations. In March 2009, the Parliamentary Budget and Finance Commission adopted the **National Strategy for the Development of Scientific Research 2009-2018**. The document envisions the gradual increase of the public expenditures for scientific research and innovations until they reach the average level for EU. The Strategy envisions the state securing financial support for new companies, which adopt high technological scientific products. The state will use different tools for risk financing – venture funds, guaranty funds, etc.

The government is trying to counteract the reflux of investments through the changes, which were made to the **Investment Encouragement Act** (IEA). Via the new levels in support of the investors announced, the scope of IEA is expanded and makes it possible for more companies to take advantage of the provided concessions. Another direction of the investment policy is the building of **industrial zones**. The Industrial Zones National Company was registered in the beginning of February with starting capital of 100 million levs; it will build and manage the industrial parks. They plan to build 20 such zones on an area of more than 500 thousand square meters.

PUBLIC FINANCES. **The public finances are stable as a whole, but February recorded a drop in the budget surplus.** Budget 2009 again provides a budgetary surplus at a level of 3 percent of GDP, as have the last years' budgets. By February the budgetary balance in the consolidated fiscal program amounted to 587.7 million levs. Compared to January 2009, there was drop of 35.2 percent and, in comparison to the level from one year ago, the decrease is about 1.3 percent. February 2009 recorded for first drop in the income collected from **VAT**

since March 2007. The drop of the revenues from VAT on an annual basis is mainly as a result of the drastic shrinkage in the volume of imports into the country and, respectively, lower revenues from the VAT on those imports, as well as from the lower prices of fuels and raw materials on the international markets. **After a slight growth in January, the fiscal reserve decreased again by February 2009.** During the first two months of the previous year the situation was the same, after which the reserve increased, but because of the current economic crisis, the optimistic version from now on is for lower growth or to maintain the level from the end of 2008.

SOCIAL AND HEALTHCARE POLICIES. The persons who are affected by the shrinkage in production have become the main priority of the active policy on the labor market. The revenues in the budget of the state's social security from the beginning of the year increased, despite the recorded increase in unemployment. The costs for pensions increased by 380 million levs under the new formula for calculating the pensions with a higher factor of replaced income for each year of insured employment. The negative profitability of the private pension funds in 2008 has not led to a real loss for the insured persons, since there are no problems with liquidity, and the funds are not forced to sell securities under the current prices of the Bulgarian Stock Exchange. The project of the Health ministry for the restructuring of the hospital network in 2009 does not include a reduction in the number of hospitals, but mainly a restructuring of operations and new criteria for the evaluation of the hospitals.

ECOLOGICAL POLICIES. A basic element in the European environmental policy is the increase of the share of *renewable energy sources (RES)* in the structure of the energy consumption of the member countries, which is now less than 1 percent. It is expected to increase quickly due to the significant investors' interest aroused in 2008 by the preferential buyout rates of RES generated power in Bulgaria and the reduced interest in many European countries towards energy from alternative sources because of its high price. The memorandum signed by EBRD in March regarding 250 million euro, with which the bank will start a program for crediting of industrial projects toward the increase of energy efficiency in Bulgaria is an additional stimulus.

The principle disagreements on the part of the EU are the reason for the suspending of the procedures of Environment Operative program in March this year, and for the review of the parts of the projects that had already been approved. A major condition for the continuation of the European funding for the *water infrastructure* is the development of a general national position and its implementation within the next months. Delay carries the risk of the envisioned 250 million euro funds for water projects in 2009 not being absorbed.

FINANCIAL SYSTEM. Up until February 2009, the monetary supply continued to slow its growth to 7.6% on an annual basis. M1 decreased by a hitherto record breaking 8.4% on an annual basis. We observed descending interest rates trends on most credits on a monthly basis, but the statistics still indicate growth on an annual basis. By February only the interest rates on "other" credits rose (by 0.52 percentage points) and consumer credits (by only 0.08 percentage points). The interest rates of the home loans fell by 0.54 percentage points on a monthly basis, but, on an annual basis, they rose by 1.72 percentage points. The interest rates on deposits during the period also began a downward move on a monthly basis, but still remain above the level from one year ago. The fact that, from December 2008, the share of the bad credits began to rise fast is alarming. In contrast to the other banking systems in the EU, the **banking sector** in Bulgaria began year 2009 with a positive financial result, generating a profit of 73 million levs during the first month. This profit adds to the undistributed financial result for 2008 and increased the capacity of the system, and of the individual credit institutions, in case of sudden changes within the parameters of their

financial condition. The liquid position of the banking system remains adequate to the structure of the resources attracted. From now on the banks are not going to impose fees on their customers if they choose to close their accounts in one bank and trust another bank. This new principle is foundational in the joint agreement between the banks in the EU and comes into force on November 1, 2009. The ascending dynamics of the **leasing market** continues. The profits of the **insurance sector** slowed their increase.

During the first quarter of 2009 the descending trend of the **capital market** continued in the country. The stock market indices fell by about 20 percent during that period, SOFIX reaching its levels from six months ago, and the broader index, BG40, falling below its starting value from February 2005. Thus, for the last 12 months, the fall of the Bulgarian stock market reached 77%, measured by SOFIX. The market capitalization for the first quarter also marked a normal fall – of 20% which is in line with the fall on the indices. A serious fall of 40 percent was recorded by the turnovers for the quarter. There is a significant fluctuation in this indicator between the individual periods and, on an annual basis, it marked an even more significant decrease of 52%. However, we have to take into account the influence of the prices of the traded instruments, which fell significantly during the last calendar year. On the other hand, the number of the traded instruments for the quarter marked a very slight fall in comparison with the first quarter of 2008; even more so, in that the first effects of the world financial crisis were just about to be felt. The low values of the indices, and of the prices of the traded stocks in particular, gives us more and more reason to think whether the market has not reached its lowest levels. On the one hand, the foundations of many companies have long since indicated minimum appropriate levels for purchase, i.e. for possible future ascending moves while, on the other hand, the market is still influenced to a great extent by purely psychological factors, which limit the possibilities of rational analysis and for reasonable forecasts, respectively.

ENERGETICS. The central heating company in the capital is owned by the state and could become a part of the Bulgarian Energy Holding. The State Water and Energy Regulatory Commission passed its judgment on the proposal of Bulgargas EAD for an 11 percent decrease in the price of natural gas for the second quarter of 2009, and on the 10.5 percent increase of the price for production and delivery of electric power requested by CEZ. Enel increased the capacity of the Enel Maritsa Iztok 3 Heating Plant to 908 megawatts with the rehabilitation of the sulphur-cleaning installation at the plant. Bulgaria will receive 105 million euro for the building of gas pipeline connections with Greece and Romania, modernization of the depository in Chiren, building a new depository at Galata, and building a Bulgarian-Greek terminal for liquefied gas in the area of the Aegean Sea.

TRANSPORT. An agreement has been signed between Bulgaria and Greece which will facilitate cross-border railway traffic. Bulgaria signed the *Code of Conduct on co-operation in the field of civil aviation incident investigation* of the European Civil Aviation Conference. Bulgaria and Romania came to agreement concerning the acceleration of the construction on Romanian territory in connection with the Danube Bridge 2. The digging of the first shaft of the Sofia metro in the Patriarh Evtimii-NDK-Cherni Vrah Blvd segment began. The Maritime Administration Executive Agency started two partner projects for clean waters. The building of the Liulin highway has been delayed again; the future of the Thrace Highway is again unknown after the EU suspended the tendering process in December 2008.

CONSTRUCTION AND REAL ESTATE. After an upward trend which lasted 6-7 years, the interest on the part of foreign and local investors decreased during the first quarter of 2009, and the direct investments in the sector are definitely not going to reach their levels from the previous year. The real estate sector in Bulgaria is in a period of price re-adjustment and profits. The market of vacation properties at the Black Sea Coast and in the mountain resorts

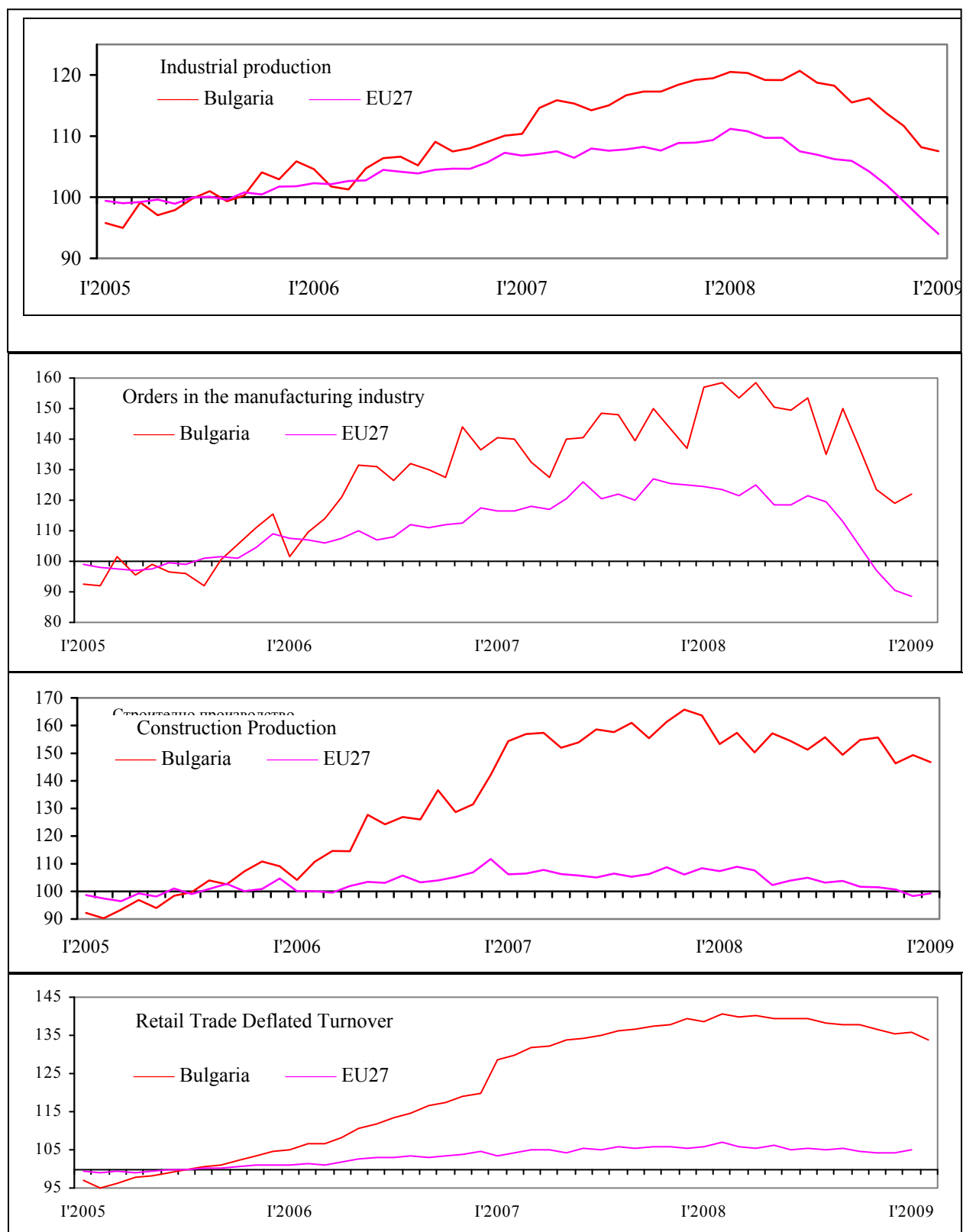
is in stagnation. This is also partially due to over construction. At the same time, the volume of the commercial areas in malls will keep growing, but with a slower rate than the period 2006-2008. The interest toward office space decreased – it is expected for the number of vacant offices to reach a double-digit percentage due to all the available administrative areas. However, in March, the business climate indicator in construction rose by 4.3 points as compared to February because of more positive evaluations by the entrepreneurs of the current situation in the construction sector and more optimistic expectations for the next months.

TOURISM. In 2008, Bulgaria was visited by 10.4 percent more foreigners than in 2007; the revenues from international tourism exceeded 2.4 billion euro and were about 11% more than 2007. Bulgarian citizens traveled abroad 29% more compared to 2007. In December, under the influence of the world economic crisis, there was a decrease in the tourist stream (about 15-20%) that continued during the first two months of 2009. The Bulgarian citizens who chose to stay in Bulgarian resorts have played an important role in the neutralization of the negative trends. In 2009 the lower demand for tourist services is likely to continue. The trend of late reservations may bring about a shortage of available resources for renovation of the hotel base. Having in mind the background of the expected difficulties in the sector, it is expedient to turn our attention to the alternative forms of tourism – rural and eco-tourism.

AGRICULTURE. The good crops of 2008 and the growing demand on the international market are reason to expect a growing importance of the sector. The problems, however, intensify: strong dependence on the climactic conditions for crop production, non-observance of the technological requirements, limited usage of means for herbal protection, disproportional development of the individual sub-sectors, difficult restructuring of the stock-breeding farms and the danger of them being closed because of their impossibility to keep to European standards, disorder in the payments of subsidies, as well as blocked funds under the European programs. In spite of all this, the sector is attractive for investors; the sifting out of uncompetitive producers will consolidate the production and will increase the importance of husbandries, which work effectively. There is growth in the experience of working on a project basis and in the absorption of resources from European funds.

REGIONAL POLICIES. EUROPEAN FUNDS. The **Intermediate Report on Progress** in Bulgaria under the Co-operation and Verification Mechanism was published in February 2009. It remarks on the measures, which were taken in the country for structural and legislative reforms of the judicial system, the prosecutor's office, internal affairs and security. According to the EU, Bulgaria needs to show that she has created an independent and stable judicial system that is capable of uncovering and punishing conflicts of interests, corruption, and organized crime. Particular measures were adopted for improving the normative order, the increase of administrative control over the departments that handle EU funds and programs, more transparency in the work of these departments, improving the system which reports irregularities, activating dialogue with EU partners, along with adopting the recommendations and best practices of the EU.

Fig.1 Indexes of industrial production, orders in manufacturing, construction and retail trade, seasonally adjusted, 2005=100, %



Source: Eurostat.